No. 13932

United States
COURT OF APPEALS
for the Ninth Circuit

UNITED STATES OF AMERICA,
Appellant,

v.

EBEN H. CARRUTHERS and NANCY CARRUTHERS,
Appellees.

On Appeal from the United States District Court for the District of Oregon

HON. CLAUDE MCCOLLOCH, District Judge

BRIEF FOR THE UNITED STATES

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CASES CITED

STATUTES

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OPINION BELOW

The findings of fact and conclusions of law of the District Court (R. 16-20) are not officially reported.

JURISDICTION

This appeal involves income tax for the taxable year 1950. The taxes in dispute were paid on February 9, 1951. (R. 18.) The taxpayers filed a timely claim for re-

fund of $3,635.92 with the Collector of Internal Revenue for the District of Oregon on October 2, 1951 (R. 4, 18); upon a failure to receive a statutory notice of disallowance of this refund claim and after the expiration of six months taxpayers filed their complaint with the District Court on June 2, 1952 (R. 18-19, 27). On November 21, 1952, the case was tried before the District Court (R. 27), after which judgment was entered on March 3, 1953 for the taxpayers in the amount of $3,635.92 plus interest (R. 21-22). The District Court had jurisdiction of this suit under 28 U.S.C., Section 1346. Notice of appeal was filed on May 1, 1953 (R. 22-23), and the time for filing the record on appeal and docketing the action in the United States Court of Appeals for the Ninth Circuit was extended by order of the District Court 90 days from April 30, 1953 on June 2, 1953 (R. 23). Jurisdiction is conferred on this Court by 28 U.S.C., Section 1291.

QUESTION PRESENTED

Whether the payments received by the taxpayer in the taxable year 1950 from the E. H. Curruthers Company for certain patent rights constituted proceeds from a sale so as to be taxable under Section 117 (b) of the Internal Revenue Code as a capital gain, or proceeds from a licensing agreement taxable as ordinary income.

STATUTE INVOLVED

The applicable provisions of the statute will be found in the Appendix, *infra*.

STATEMENT

The facts were found by the District Court as follows (R. 16-19):

Taxpayers instituted this action to recover individual income taxes collected from them by a former Collector of Internal Revenue of the United States for the District of Oregon, for the calendar year 1950. (R. 16.)

Taxpayers, husband and wife, are and at all times material herein were residents and inhabitants of Clatsop County, Oregon. During the period from September 1, 1947, to November 1, 1952, Hugh H. Earle was the Collector of Internal Revenue for the District of Oregon. (R. 17.)

On May 27, 1950, taxpayer Eben H. Carruthers entered into a contract with the E. H. Carruthers Company, an Oregon corporation (Ex. 4), and on May 31, 1950, taxpayer Eben H. Carruthers entered into a "license agreement" with the same corporation (Ex. 5), under the terms of which he granted to the company "an exclusive license to manufacture, use, sell or lease machinery or to practice any method in accordance with or as set forth in certain United States and foreign patents and applications for patents, together with the right to sub-license others", as more fully stated in the agreement. The exclusive license was "limited to the tuna canning industry", but extended "to the end of the term of any patent listed or to the end of the term of any patent which may issue upon a patent application listed." (R. 17.)

The inventions of the taxpayer, Eben H. Carruthers, which were the subject of the aforementioned agreements, had been reduced to practice more than six months' prior to May 27, 1950. (R. 18).

On February 9, 1951, taxpayers filed a joint income tax return for the year 1950, reporting a total net income of $36,927.44 and a tax liability of $10,581.98, which was duly paid. In this return the taxpayers included as ordinary gross income the total amount of $38,976.75, received from the E. H. Carruthers Company in accordance with paragraphs 2, 3, and 4, of the contract of May 27, 1950. (R. 18.)

On October 2, 1951, the taxpayers filed an amended joint income tax return showing a net income of $28,-419.02 and a timely claim for refund on Form 843 for $3,635.92, upon the ground that the amount of $17,-016.75 received by the taxpayer Eben H. Carruthers in the year 1950, as provided in paragraph 4 of the contract of May 27, 1950 (Ex. 4), represented profit to him on the sale of patent rights as a long-term capital gain rather than ordinary income to him. (R. 18.)

Taxpayers did not receive a statutory notice of the disallowance of their refund claim, as provided in Section 3772 (a)(2) of the Internal Revenue Code, but more than six months expired between the filing of the refund claim and the commencement of this action. (R. 18-19.)

The license agreement dated May 31, 1950 (Ex. 5), constituted an absolute assignment and sale of all of the inventions, applications for patent and patents described therein. The amount of $17,016.75 received by the tax-

payer Eben H. Carruthers in the year 1950 as "royalties" was in consideration of such assignment and sale. (R. 19.)

The inventions, applications for patent and patents described in the aforementioned agreement did not constitute property held by the taxpayer Eben H. Carruthers primarily for sale to customers in the ordinary course of trade or business. (R. 19.)

STATEMENT OF POINTS TO BE URGED

A statement of points upon which the Government relies is set forth in the record. (R. 24-25.) It may be summarized as follows:

The court erred in finding and concluding that the license agreement, dated May 31, 1950, constituted an absolute assignment and sale of all the inventions, patents, and applications for patents described therein; and in concluding that the amounts received by the tax payer* in 1950 were reportable as a long term capital gain and therefore taxpayers were entitled to recover judgment.

SUMMARY OF ARGUMENT

The District Court's conclusion that the taxpayer's contract of May 27, 1950, constituted a "sale of said inventions, applications for patent and patents" listed in the license agreement of May 31, 1950, depends for

*Eben H. Carruthers will hereinafter be referred to as the taxpayer.

its validity upon the legal determination of what constitutes a sale as differentiated from a lease of a patent. Whether a transfer of an interest or a right under a patent is a sale or only a license does not depend upon the terminology used by the parties. However, to constitute a sale, the conveying instrument must be unambiguous and show a clear and unmistakable intent to part with the patent.

It should be noted at this point that this is not the first, and perhaps not the last, license of these patents between the same parties. In fact some of the patents which had been previously assigned by the taxpayer to the E. H. Carruthers Company were reassigned to him with the understanding that he would grant the company a license to manufacture, use, sell or lease machinery in accordance with the license only within the tuna industry.

Taxpayer's subsequent license agreement and contract with the company have various features indicative of a license as distinguished from a sale and complete transfer of title.

A. The language of the license agreement entered into by the parties was insufficient to transfer the entire right, title and interest in the patents to the company. That fact is borne out by the language of the agreement and the lower court's finding that the license was limited to the tuna canning industry. Here, therefore, the Company only acquired the right to use the patents in one industry. However, the company realizing, as admitted by taxpayer, that the patents involved here could be

used in other industries procured a first option to purchase a license to manufacture, use, sell or lease any machine, device or apparatus the taxpayer might perfect under these patents which might be useful outside the tuna industry. We therefore submit that taxpayer's failure to part with the whole bundle of rights is fatal to and incompatible with the idea of a sale. Therefore the relationship drawn up here was that of a licensor and licensee and accordingly the payments received were taxable as ordinary income rather than as capital gain.

B. Under taxpayer's agreement with the company the latter was obligated to pay him eight percent of its gross receipts from use of the machines on which he controlled the patents. Thus it is apparent that the taxpayer retained the right to receive royalties from the profitable exploitation of his patents and that any amounts received by him pursuant to the contract constituted royalties from the lease of the patents taxable as ordinary income.

Therefore, contrary to the lower court's finding and conclusion, taxpayer's agreement and contract with the company constituted a lease not a sale of the patents and the amounts received thereunder were reportable as ordinary income and taxpayers were not entitled to a refund.

ARGUMENT

Taxpayer's Agreement with the E. H. Carruthers Company Constituted a License, Not a Sale

The District Court's conclusion (R. 19-20) that the taxpayer's contract of May 27, 1950 (R. 53-57), with the E. H. Carruthers Company constituted an absolute "assignment" and "sale" of his inventions, applications for patent and patents listed in the license agreement of May 31, 1950 (R. 57-61), to the aforementioned company necessarily depends for its validity upon the conformity of the contract with the legal concept of what constitutes a sale of a patent. The distinction between an asignment of a patent (which for a consideration would be a sale) and a license was stated long ago in *Waterman v. Mackenzie,* 138 U.S. 252, which is the "leading case" on the subject, and was reiterated in *United States v. Gen. Elec. Co.,* 272 U.S. 476, and in this Court's opinion in *Six Wheel Corp. v. Sterling Motor Truck Co.,* 50 F. 2d 568, 571-572. Quoting from *Waterman v. Mackenzie,* (p. 255), the distinction is as follows:

> The patentee or his assigns may, by instrument in writing, assign, grant and convey, either, 1st. the whole patent, comprising the exclusive right to make, use and vend the invention throughout the United States; or, 2d, an undivided part or share of that exclusive right; or, 3d, the exclusive right under the patent within and throughout a specified part of the United States. * * * A transfer of either of these three kinds of interests is an assignment, properly speaking, and vests in the assignee a title in so much of the patent itself, * * *. Any assignment or transfer, short of one of these, is a mere license, giving

> the licensee no title in the patent, and no right to sue at law in his own name for in infringement. * * * In equity, as at law, when the transfer amounts to a license only, the title remains in the owner of the patent; * * *.

The distinction thus drawn has been repeatedly applied in tax cases. *Gregg v. Commissioner,* 18 T.C. 291, affirmed *per curium,* 203 F. 2d 954 (C.A. 3d); *Broderick v. Neale,* 201 F. 2d 621 (C.A. 10th); *Bloch v. United States,* 200 F. 2d 63 (C.A. 2d); *Allen v. Werner,* 190 F. 2d 840 (C.A. 5th); *Kavanagh v. Evans,* 188 F. 2d 234 (C.A. 6th); *Hook v. Hook & Ackerman,* 187 F. 2d 52 (C.A. 3d); *Commissioner v. Celanese Corp.,* 140 F. 2d 339 (C.A.D.C.); *General Aniline & Film Corp. v. Commissioner,* 139 F. 2d 759 (C.A. 2d), and *Kronner v. United States,* 110 F. Supp. 730 (C.Cls.). Whether the transfer of an interest or right under a patent is a sale or only a license does not depend upon the terminology used by the parties (*Waterman v. Mackenzie, supra,* p. 556), here that of a "license" (R. 57), but to constitute a sale "the instrument of transfer must be unambigous and show a clear and unmistakable intent to part with the patent." *Kenyon v. Automatic Instrument Co.,* 160 F. 2d 878, 882 (C.A. 6th).

That the instrument involved here was intended as a license and not an assignment is clearly demonstrated by the prior transactions between the taxpayer and the company in relation to the patents. Taxpayer first assigned some of the patents involved to the company. At a special meeting of the stockholders of the latter it was decided to reassign the aforementioned patents to the taxpayer *with the understanding that he would retain*

full title to any present and all future inventions and patents but would grant the company a license to manufacture, use, sell or lease machinery in accordance with the agreement solely for the tuna industry. The directors also decided to pay taxpayer eight percent of the gross receipts received by the company from the limited use of his patents. (R. 41-51.) It was pursuant to the foregoing that the instruments involved here were executed.

Taxpayer's subsequent "license agreement" and contract with the company also have various features indicative of a license, as distinguished from a sale and complete transfer of title. These matters will be considered separately below.

A. *The language of the agreement.*

The language of the license agreement of May 31, 1950, is insufficient as a transfer of the entire right, title and interest in the patents to the company. Section 2 of the agreement merely states that (R. 60):

> *The exclusive license set forth above is limited to the tuna canning industry* but shall extend to the end of the term of any patent listed or to the end of the term of any patent which may issue upon a patent application * * *. (Italics supplied.)

And the trial court found that (R. 17):

> The exclusive license was "limited to the tuna canning industry", * * *.

Here, therefore, when the taxpayer split off the above mentioned right, the company did not become the owner of the patents, patent rights, etc., themselves but ac-

quired only what limited and lesser rights were specifically granted by the terms of the agreement. In fact, the taxpayer himself testified before the lower court that he thought his patents could be applied to another industry. (R. 33-35.) It was for that very reason that the board of directors of the company directed their company to enter into a contract with the taxpayer for the first option to purchase a license to manufacture, use, sell or lease any machine, device or apparatus of his which would be useful outside the tuna industry (R. 48-50); this direction was carried out (R. 53, 61).

B. *The Payments received by the taxpayer under the Contract.*

Pursuant to the taxpayer's agreement of May 27, 1950, with the company, the latter was obligated to pay (R.55)—

> to Carruthers an amount equal to eight per cent (8%) of the gross receipts of E. H. Carruthers Company *resulting from any machines upon which Carruthers controls the patents.* * * * (Italics supplied.)

Thus, we are once again confronted with taxpayer's retention of an instrinsic right, conferred on him by the patenting of the machinery, i.e., the right to profitably exploit the patented articles by receiving a percentage of the gross receipts from their sale or rental. We submit that the amounts paid under the above mentioned provision of the contract constituted royalties from the lease of the taxpayer's patents applicable to the tuna canning industry rather than the proceeds from a sale taxtble as a captial gain.

Accordingly, it is apparent, contrary to the District Court's conclusion, that due to the taxpayer's retention of rights under the patents, his agreement and contract with the company, constituted a lease, not a sale, and the proceeds were properly reported as ordinary income rather than as capital gain.

CONCLUSION

The decision of the District Court is wrong and should therefore be reversed by this Court.

Respectfully submitted,

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DECEMBER, 1953.

APPENDIX

INTERNAL REVENUE CODE:

SEC. 22 [as amended by Sec. 1 of the Public Salary Tax Act of 1939, c. 59, 53 Stat. 574]. GROSS INCOME.

(a) *General Definition.* — "Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * *

(26 U.S.C. 1946 ed., Sec. 22.)

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) *Capital Assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used

in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (1), * * *;

* * * *

(4) [as amended by Sec. 150 (a) (1) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Long-Term Capital Gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing net income;

* * * *

(b) [As amended by Sec. 150 (c) of the Revenue Act of 1942, *supra*] *Percentage Taken Into Account.*— In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income:

100 per centum if the capital asset has been held for not more than 6 months;

50 per centum if the capital asset has been held for more than 6 months.

* * * *

(26 U.S.C. 1946 ed., Sec. 117.)